DEPARTMENT OF STATE REVENUE

04-20140098.LOF

Letter of Findings: 04-20140098
Gross Retail Tail Tax
For the Year 2010

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and circumstances. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

ISSUES

I. Tax Administration – Fraud Penalty.

Authority: IC § 6-8.1-10-4; 45 IAC 15-5-7; 45 IAC 15-11-2(b); 45 IAC 15-11-4; Black's Law Dictionary (9th ed. 2009).
Taxpayer challenges the Department of Revenue's decision imposing a 100 percent fraud penalty stemming from the use tax assessment on the purchase of a recreational vehicle.

II. Gross Retail and Use Tax – Recreational Vehicle Purchase.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-3-2(a); IC § 6-2.5-4-1(b), (c); IC § 6-8.1-5-1(c); 45 IAC 2.2-3-4; Gregory v. Helvering, 293 U.S. 465 (1935); Lee v. Comm'r, 155 F.3d 584 (2d Cir. 1998); Horn v. Comm'r, 968 F.2d 1229, (D.C. Cir. 1992); Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570 (2d Cir. 1949); Helvering v. Gregory, 69 F.2d 809 (2d Cir.1934); Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); Fell v. West, 73 N.E. 719 (Ind. App. 1905); Dept. of Treasury v. Dietzen's Estate, 21 N.E.2d 137 (Ind. 1939); Letter of Findings 04-20100111 (March 29, 2010); Letter of Findings 04-20100299 (July 28, 2010); Letter of Findings 04-20100175 (August 23, 2010).

Taxpayer disagrees with the Department of Revenue's decision imposing a sales/use tax assessment on the purchase of a recreational vehicle.

STATEMENT OF FACTS

Taxpayer disputes the assessment of use tax on the purchase of a recreational vehicle. There are three interested parties; a Montana LLC, Taxpayer, and Taxpayer's president. Taxpayer is a farming business and is the only member of the LLC. The Indiana Department of Revenue ("Department") issued Taxpayer's president a use tax assessment. Taxpayer's president protested the assessment, an administrative hearing was conducted during which the president's representative explained the basis for the protest. A Letter of Findings (Letter of Findings 04-20110504) was issued denying this first protest.

Subsequently, the Department issued a second assessment against Taxpayer (the farming business). Taxpayer's representative challenged this second assessment, and an administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Tax Administration – Fraud Penalty.

DISCUSSION

Along with challenging the underlying assessment of sales/use tax on the purchase of a vehicle, Taxpayer also challenges the assessment of the fraud penalty which had the effect of doubling the underlying assessment. Taxpayer states that the fraud penalty is "neither applicable nor proper." Taxpayer further argues that imposition of the penalty represents "the use of strong-armed, improper and slanderous tactics by the Department of Revenue . . . ."

The fraud penalty is found at IC § 6-8.1-10-4, which states:

> (a) If a person fails to file a return or to make a full tax payment with that return with the fraudulent intent of evading the tax, the person is subject to a penalty.

(b) The amount of the penalty imposed for a fraudulent failure described in subsection (a) is one hundred percent (100[percent]) multiplied by:

(1) the full amount of the tax, if the person failed to file a return; or

(2) the amount of the tax that is not paid, if the person failed to pay the full amount of the tax.

(c) In addition to the civil penalty imposed under this section, a person who knowingly fails to file a return with the department or fails to pay the tax due under IC 6-6-5, IC 6-6-5.1, or IC 6-6-5.5 commits a Class A misdemeanor.

(d) The penalty imposed under this section is imposed in place of and not in addition to the penalty imposed under section 2.1 of this chapter.

The rule is restated in the Department's regulation at 45 IAC 15-11-4 which states:

The penalty for failure to file a return or to make full payment with that return with the fraudulent intent of evading the tax is one hundred percent (100[percent]) of the tax owing. Fraudulent intent encompasses the making of a misrepresentation of a material fact (See 45 IAC 15-5-7(f)(3) which is known (See 45 IAC 15-5-7(f)(3)(B)) to be false, or believed not to be true, in order to evade taxes. Negligence, whether slight or great, is not equivalent to the intent required. An act is fraudulent if it is an actual, intentional wrongdoing, and the intent required is the specific purpose of evading tax believed to be owing.

It should be noted that imposition of the penalty affects the time during which the Department may issue an assessment. 45 IAC 15-5-7 provides in relevant part:

(f) The running of the statute of limitations for purposes of assessing unpaid taxes will not start if the taxpayer fails to file a return which is required by any listed tax provision. Also, a substantially blank, unsigned or fraudulent return will not start the running of the statute of limitations.

(1) A substantially blank return is one which does not furnish all the information necessary to determine a taxpayer's liability for the tax in question. In order for a return to be complete enough to determine the taxpayer's liability, the information does not have to be correct. Any denotion by the taxpayer which clearly indicates a positive denial of liability for any tax listed on the tax form shall constitute a completed return. Thus, a return which has "zero," or "-0-"or "none" written on a given line is not substantially blank. Also, if a taxpayer makes a positive indication of liability on a line which constitutes a total of one or more taxes, a return is deemed to be completed for all such taxes even if the particular line for the tax(es) is left blank.

(2) An unsigned return is one which does not have the original hand written signature of the individual taxpayer or corporate officer or their authorized designee. The return also must be dated.

(3) A person who files a return which makes a false representation(s) with knowledge or reckless ignorance of the falsity will be deemed to have filed a fraudulent return. There are five elements to fraud.

(A) Misrepresentation of a material fact: A person must truthfully and correctly report all information required by the Indiana Code and the department's regulations. Any failure to correctly report such information is a misrepresentation of a material fact. Failure to file a return may be a misrepresentation.

(B) Scienter: This is a legal term meaning guilty knowledge or previous knowledge of a state of facts, such as evasion of tax, which it was a person's duty to guard against. A person must have actual knowledge of the responsibility of reporting the information under contention. However, the reckless making of statements without regard to their truth or falsity may serve as an imputation of scienter for purpose of proving fraud.

(C) Deception: Deception operates on the mind of the victim of the fraud. If a person's actions or failure to act causes the department to believe a given set of facts which are not true, the person has deceived the department.

(D) Reliance: Reliance also concerns the state of mind of the victim and is generally considered along with deception. If the person's actions, failure to act, or misrepresentations cause the department to rely

on these acts to the detriment or injury of the department, the reliance requirement of fraud will be met.

(E) Injury: The fraud instituted upon the department must cause an injury. This can be satisfied simply by the fact that the misrepresentation(s) caused the department not to have collected the money which properly belongs to the state of Indiana.

In order to demonstrate fraud, the department is required to prove all of the above elements are present. This must be shown by clear and convincing evidence.

(Emphasis added).

The negligence penalty is found at 45 IAC 15-11-2(b) which provides:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

Assuming for the moment that the proposed assessment of sales/use tax was correct and that the Department properly assessed use tax on the out-of-state acquisitions the recreational vehicles, the Department must determine whether the 100 percent penalty was properly imposed.

Taxpayer – as the "sole member of the Montana LLC" – conferred with a Montana lawyer to establish the LLC to hold title to the vehicle. A cursory search of publicly available information reveals that this attorney offers various services to its clients stating that, "Register your vehicle in Montana. Avoid sales tax and licensing fees. Forming a Montana business entity (Montana LLC or Corporation) may allow you to avoid sales tax and lower your licensing fees on your automobile, recreational vehicle, trailer, boat or airplane."

The attorney reassures potential clients stating that, "A simple legal procedure is involved which, in most cases, helps [our] clients save a great deal of money on taxes and licensing fees through creating a Montana LLC and then proceeding with Montana vehicle registration or Montana RV registration within the legal bounds of a Montana LLC."

The Montana Secretary of State duly approved the filing of the documents for the LLC. Purportedly acting as an "agent" for the LLC, Taxpayer's president proceeded to purchase the recreational vehicle. The LLC then "took possession" of the recreational vehicle. Taxpayer asserts that the recreational vehicle was then "titled to the Montana LLC" because Montana was the legal residence of the LLC.

In order to sustain the imposition of the penalty, the statute requires that all five elements – misrepresentation, scienter, deception, knowledge, injury – be established. In this instance, it is sufficient to review the "scienter" requirement. The term is defined as follows:

A degree of knowledge that makes a person legally responsible for the consequence of his or her act or omissions . . . [a] mental state consisting in an intent to deceive, manipulate, or defraud. Black's Law Dictionary 1463 (9th ed. 2009).

However unlikely the legal contortions may have been, Taxpayer (or Montana LLC or Taxpayer's president) apparently consulted the Montana attorney in good faith, paid that attorney to establish a Montana LLC, and believed the attorney's explanation that establishing the LLC would allow Taxpayer to avoid paying Indiana sales or use tax. As such, it is not possible to establish – by "clear and convincing evidence" – that Taxpayer possessed the requisite "degree of knowledge" or scienter sufficient to sustain the imposition of the 100 percent penalty.

FINDING

Taxpayer's protest is sustained.

II. Gross Retail and Use Tax – Recreational Vehicle Purchase.

DISCUSSION

Montana LLC purchased a recreational vehicle from a Florida dealership. The recreational vehicle cost approximately $500,000. The dealership did not collect, and Montana LLC did not pay, Florida's six-percent sales tax. The "purchase contract" stated that sales tax was "N/A." Taxpayer does not explain why Florida sales tax was inapplicable except to say that the "tax was deferred to the State of Montana . . . ."

Taxpayer explains that its president "completed the purchase of the RV on behalf of and as an agent for his corporation and the corporation's LLC."

Thereafter, the recreational vehicle was titled to the Montana LLC which – as Taxpayer explains – is the "legal residence of the LLC." Taxpayer further explains that the recreational vehicle "was purchased by the Montana LLC for use by the [Taxpayer] in its business and personal use by the shareholder[], for travel and vacationing primarily outside of the State of Indiana." Although Taxpayer argues that the recreational vehicle was used outside of Indiana, Taxpayer was unable to provide any documentation establishing the amount of time the vehicle was used outside Indiana.

The Department assessed Taxpayer use tax on the purchase of the recreational vehicle. The Department imposed use tax after determining that no sales tax had been paid on the purchase of the recreational vehicle.

Taxpayer disagrees with the assessment relying partly on the proposition that no sales tax was owed to Florida or Montana and that the Department is required to defer to those states under the Full Faith and Credit Clause of the United States Constitution. (U.S. Const. art. IV § 1). Taxpayer protests that the recreational vehicle was titled by a Montana LLC and that all legal documents establishing the existence of the LLC were properly filed in Montana. Taxpayer additionally maintains that the Montana LLC had a legitimate purpose, Taxpayer used the recreational vehicle for purposes related to its farming operation, and that the vehicle was used primarily outside Indiana.

As a threshold issue, it is Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." As Indiana courts have long held, "In construing tax statutes a liberal rule of interpretation must be indulged in order to aid the taxing power of the state." Dept. of Treasury of Ind. v. Dietzen's Estate, 21 N.E.2d 137, 139 (Ind. 1939). "The statutes of this state relating to the assessment and collection of taxes are liberally construed in favor of the taxing powers." Fell v. West, 73 N.E. 719, 722 (Ind. App. 1905).

The sales tax is imposed by IC § 6-2.5-2-1, which states:

> (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
>
> (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

The use tax is imposed under IC § 6-2.5-3-2(a), which states:

> An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

The Department's regulation, 45 IAC 2.2-3-4, provides:

> Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

The use tax is functionally equivalent to the sales tax. See Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002). By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. Id.; USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466, 468–69 (Ind. Tax Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To

trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. Rhoade, 774 N.E.2d at 1048. A taxable retail transaction occurs when; (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

In its original contact letter to the Taxpayer's president, the Department explained that use tax was being assessed because "sales tax was not paid to the vendor." The Department recognized that the vehicle(s) "was titled in the state of Montana in the name of a LLC" but that the Department "believed the RV is the only asset of the LLC and the LLC serves no other purpose but to avoid Indiana sales/use taxes due for vehicles that are otherwise garaged, serviced, and/or driven in Indiana by you as Indiana residents."

Taxpayer's president stated that he "is an individual, who had no part, individually, in the purchase of this RV from a Florida dealer" and "there is no legal basis to assess or tax him individually." Both Taxpayer's president and Taxpayer correctly point out there is nothing in the law which requires that a taxpayer maximize his or her tax liability but that "[a]nyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir.1934).

However it should also be pointed out that in the Supreme Court decision Gregory v. Helvering, 293 U.S. 465 (1935), challenging the previously cited decision, the Court stated that in order to qualify for favorable tax treatment, a business reorganization must be motivated by the furtherance of a legitimate corporate business purpose. Id. at 469. A business activity undertaken merely for the purpose of avoiding taxes was without substance and "to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id. at 470.

The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial or industrial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949), cert. denied, 338 U.S. 955 (1950). "[T]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. Horn v. Comm'r, 968 F.2d 1229, 1236 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; "(1) did the transaction have a reasonable prospect, ex ante, for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?" Id. at 1237. The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual one. Lee v. Comm'r, 155 F.3d 584, 586 (2d Cir. 1998).

Taxpayer sets out putative reasons for titling a recreational vehicle in Montana but also points out that Montana does not require a business purpose to create or organize a Limited Liability Company and that the Department is constitutionally required to extend "full faith and credit" to Montana's decision that the recreational vehicles are not subject to sales and use tax. In addition, Taxpayer explains that the LLC was formed to insulate Taxpayer's Indiana business from any potential liability attributable to the recreational vehicle. In addition, Taxpayer explains that he uses the recreational vehicle to travel from state to state in order to examine farming practices in other states and the recreational vehicle is only temporarily stored in Indiana.

The Department does not deny that the LLC may have been formed for a purpose other than avoiding the tax. However, in determining that Taxpayer was entitled to rely on the representations of the Montana attorney to the extent that Taxpayer did not knowingly commit fraud, the Department also reasonably notes the attorney's own representations that the purpose of establishing a Montana LLC is to "save a great deal of money on taxes and licensing fees . . . ."

The Department is unable to agree that Taxpayer has met its burden under IC § 6-8.1-5-1(c) of demonstrating that the recreational vehicle is not used or stored in Indiana and that the Department erred in requiring an Indiana resident from paying use tax on a vehicle purchased outside the state.

Unfortunately, the Department is unable to accept the proposition that Indiana residents may avoid paying sales and use tax on tangible personal property simply by titling that property outside the state. In this particular case, the Department is unable to agree that either the law, the facts presented by Taxpayer, or simple common sense compel the conclusion that Taxpayer should not be responsible for paying use tax on this vehicle. Department has consistently determined as much. See Letter of Findings 04-20100111 (March 29, 2010), 20100526 Ind. Reg.

045100324NRA; Letter of Findings 04-20100299 (July 28, 2010), 20100929 Ind. Reg. 045100591NRA; Letter of Findings 04-20100175 (August 23, 2010), 20101027 Ind. Reg. 045100650NRA.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

Taxpayer has established that the fraud penalty should be abated. Taxpayer has not demonstrated that the purchase of the recreational vehicle is not subject to Indiana use tax.

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